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The 51st State Weighs In

Chief Network Correspondent: It's been a long 24 hours as we preside yet again over what appears to be a statistical dead heat among voters in the 48 continental states and Alaska and Hawaii. Let's turn now to our chief Asian correspondent for the view across the Pacific.

Asian Correspondent: *Now that China has formally joined the United States as the 51st state, what happens here is clearly going to determine the outcome of this election. And no pun intended, but China is definitely a Red State in this election.*

Chief Network Correspondent: *So there you have it, folks. XYZ News is now officially declaring China for George Bush, with all 1,500 of its Electoral College votes going to the Republican incumbent.*

Okay, okay, your humble servant may have drifted into the fever swamps with this little Election Day reverie. China does not have a *direct* vote in U.S. elections, even though its economy is becoming increasingly integrated with that of the U.S. However, there is no doubt that China had a huge *indirect* influence on the U.S. election outcome, and in that sense acted as a Red State – i.e. in a way that helped the Republican incumbent.

Understanding the symbiotic financial and economic relationship between the U.S. and China is going to become increasingly important for investors and policymakers alike in coming years. As a wise man once said, "Money Talks, Bologna Walks" – or something to that effect. And Chinese money spoke loudly in the runup to the U.S. presidential election.

Consider Chart 1, which shows that China increased its foreign exchange reserves by over $200 billion US in the last two years, with the bulk of those reserves flowing directly into U.S. Treasury bonds. This massive flow of funds helped keep U.S. interest rates low. That helped keep U.S. consumers happy, which undoubtedly helped George Bush in the polls. Against this backdrop, no wonder some Washington wags were referring to him as "The Manchurian Candidate."

To be sure, the Chinese did not make this investment as a personal favour to George Bush. Had they not done so, they would have seen their currency soar against the U.S. dollar. That could have put a severe dent in their export industries and threatened social and financial stability in China. The U.S. is China's most important export market and therefore China's motives have been entirely commercial: they have provided generous "vendor financing" to their most important customer. Put differently, they are "monetizing" the large U.S. trade deficit – which is running at an annual rate of about $150 billion against China. What a deal for the United States – Americans send them little pieces of paper and they fill America's Wal-Marts with $29 DVD players!

How Long Will It Last?

How long could they keep doing this? Well, as long as they want. The perceived cost to the Chinese of buying U.S. Treasury bonds is close to zero. They simply print yuan (or create it digitally) and use that money to buy U.S. Treasury bonds.

In effect, even if China is not the 51st state, its central bank is acting as if it were the 13th district of the U.S. Federal Reserve System. By printing money at just the right pace to keep its currency pegged to the U.S. dollar, the Chinese central bank has virtually abandoned its independence and outsourced its role to the Fed.

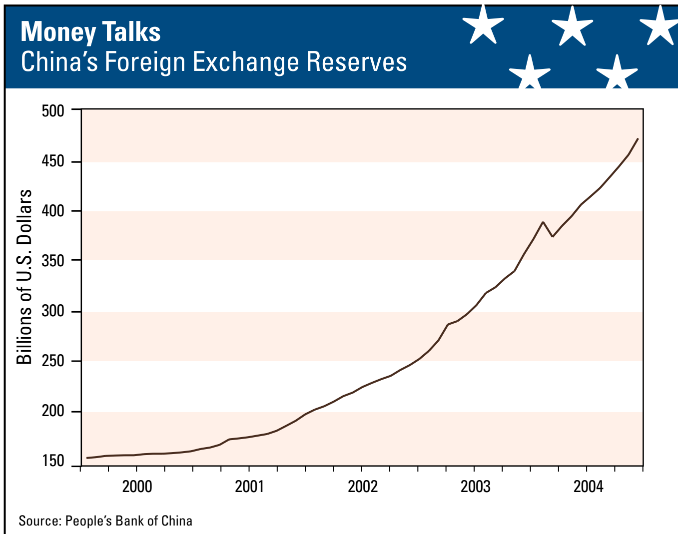

Chart 1: China's massive purchases of U.S. Treasury Bonds have been a key factor helping to keep the U.S. economy healthy ahead of the presidential election.

Japan has been pursuing a similar approach for years, albeit with a more flexible exchange rate policy. In fact, Japan's foreign exchange reserves now stand at nearly $830 billion, compared with China's relatively ho-hum $500 billion. Perhaps it is the Bank of Japan that is really the 13th Federal Reserve Bank and the Bank of China is the 14th. China has very carefully studied Japan's export-led development model for catching up to the West, and that has led China to emulate Japan's mercantilist approach to accumulating U.S. dollar reserves as well.

Incidentally, it is worth noting that Japan's approach did not ultimately prevent the yen from appreciating massively against the U.S. dollar over the years. Most economists believe it is inevitable that China's currency will appreciate significantly against the U.S. dollar.

MAD Logic

For investors, this is all very unsettling. It doesn't seem healthy for any country to run large trade deficits for an extended period of time. It "wouldn't be prudent" as George H.W. Bush might have said. However, if it can indeed go on for a long, long time, it also does not make sense to predict apocalypse around every corner. Earlier this year, former U.S. Treasury Secretary Larry Summers made some extremely provocative comments about this issue:

"There is surely something odd about the world's greatest power being the world's greatest debtor. In order to finance prevailing levels of consumption and investment, must the United States be as dependent as it is on the discretionary acts of what are inevitably political entities in other countries? It is true and can be argued forcefully that the incentive for Japan or China to dump treasury bills at a rapid rate is not very strong, given the consequences it would have for their own economies. That is a powerful argument, and it is a reason a prudent person would avoid immediate concern. But it surely cannot be prudent for us as a country to rely on a kind of balance of financial terror to hold back reserve sales that would threaten our stability."

"Balance of Financial Terror"? Mr. Summer's description of the international monetary system is reminiscent of the cold war logic of "mutually assured destruction," also known as MAD. The odd thing about MAD was that it was both terrifying – you destroy us, then we'll destroy you – and also very stable in a Doctor Stangelovian fashion. ("Gee I wish we had one of them Doomsday machines!") Faced with mutually assured destruction, rational policymakers on both sides of the table typically opt for stability.

So this somewhat scary backdrop could actually be construed as bullish. If the world has in fact meandered into a new global monetary system that will permit substantial trade imbalances to go on for an extended period, then fears

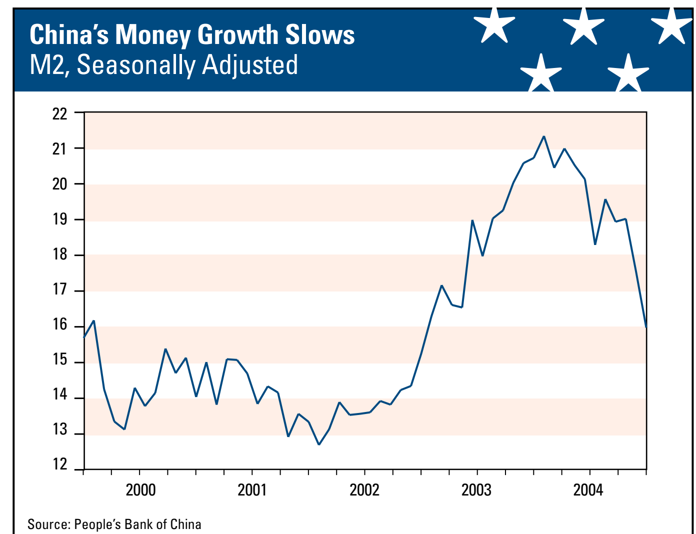

Chart 2: China has paid a clear price for its massive monetary easing in the form of accelerating inflation. Stability-minded officials have now started to tap on the brakes.

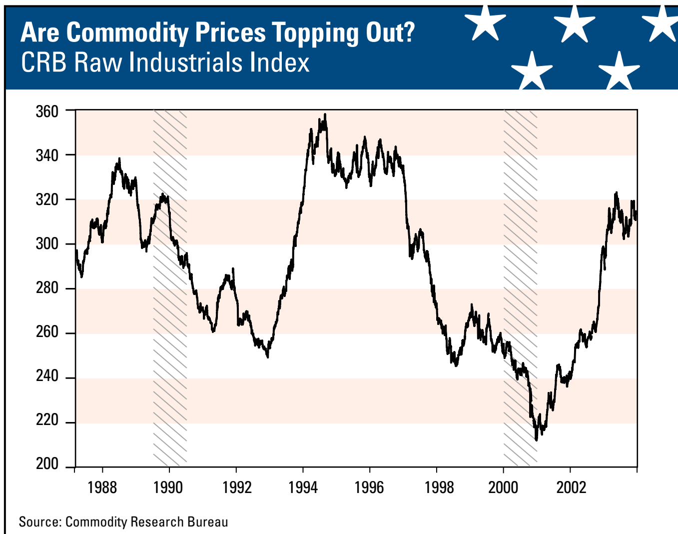

Chart 3: As China's economy begins to cool, commodity prices should take a breather – as in the mid-90s.

of financial Armageddon may be greatly overstated. This is not to say that policymakers will ignore the issue, and Mr. Summer's March 23 speech (available at www.iie.org) was indeed a call to action.

In our opinion, U.S. policymakers will aim for a "soft landing" for the U.S. trade imbalance. That will almost certainly require stronger growth in many overseas economies and a weaker U.S. dollar. That is one key reason we believe other equity markets will outperform the U.S. over the next few years.

China: Hard or Soft Landing?

Now back to the 51st state for a moment. One fly in the ointment is China's likely economic slowdown. China has paid a price for its loose monetary policy in that inflation has accelerated to more than 5% per annum. To slow its economy, China instituted credit controls in April and recently hiked interest rates for the first time in nine years. As shown in Chart 2, China's money growth has already started to slow down. More rate hikes are expected in coming quarters, although Chinese officials will undoubtedly try to engineer a "soft landing" for the economy. Ideally, what they would like to see is a slowdown in the industrial side of the economy offset by a pickup in consumer spending – and they may well use administrative guidance of bank lending to achieve that outcome.

Accordingly, some economists are predicting a "hard landing" for Chinese industrial output, but a "soft landing" for the overall economy as bank lending is directed to supporting consumer spending. Based on this scenario, overall economic growth should slow from 9% currently to 7% in 2005. That would hardly constitute a disaster for the world economy.

What is clear is that what happens in China will be an increasingly important influence on the global business cycle for years to come. Even though China only represents about one-eighth of the world economy, its GDP growth rate has been about 10 times more volatile than that of the United States – as is the case with other emerging markets. In the past few years, China has accounted for about one-third of global GDP growth, which is far more than one would have expected based on its share of world GDP.

The key impact of China's boom on global markets in recent years was felt in commodity markets. As shown in Chart 3, the CRB commodities index soared from 2001 to early 2004 based largely on China's economic surge. Now that China is beginning to tap on the brakes, we would caution investors about getting too excited about resource-oriented investment themes. Aside from oil, commodity indexes have been moving sideways since April when China announced credit controls. If anything, we suspect there will be additional downward pressure on oil and other commodity prices next year as China's industrial sector slows. For much of the world, lower commodity prices should be good news, since soaring prices put pressure on profit margins and economic growth.

Granted, China is not the 51st State of the Union. But in both economic and geopolitical terms, it now has a big seat at the table. As investors, we are all China watchers now. And if you think analyzing the U.S. political system is challenging, wait until you try understanding China's Central Politburo.

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